STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

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Illinois Bell Telephone Company	)	
	)	**ICC Docket No. 02-0864**
Filing to Increase Unbundled Loop and Nonrecurring Rates	)	
	)	

DIRECT TESTIMONY

OF

LEE L. SELWYN

ON BEHALF OF

AT&T COMMUNICATIONS OF ILLINOIS, INC.

AT&T Ex. 1.0

February 20, 2004

I. INTRODUCTION

Q. Please state your name, business address and sponsoring organization.

A. My name is Lee L. Selwyn. My business address is Two Center Plaza, Suite 400, Boston, Massachusetts 02108. I am President of Economics and Technology, Inc. ("ETI"), a research and consulting organization specializing in telecommunications economies, regulation, management and public policy.

Q. Please summarize your educational background and previous experience in the field of telecommunications regulation and policy.

A. I have prepared a Statement of Qualifications, which is provided as Attachment LLS-8 hereto.

Q. Dr. Selwyn, have you previously testified before the Illinois Commerce Commission?

A. Yes, I have testified before this Commission in a number of rate and policymaking proceedings involving SBC Illinois and its predecessors, Ameritech Illinois and Illinois Bell Telephone Company, dating back to the mid-1970s. I testified in a number of Illinois Bell general rate cases, Dockets 59666

(September 1975), 76-0409 (January 1977), 78-0034 (June 1978), 80-0010 (July 1980), and 83-0142 (November 1985 and January 1986), all on behalf of the Illinois Retail Merchants Association. I also testified in Docket 81-0478, also a general rate case (November 1981), on behalf of the Communications Users of Illinois. I testified in Docket No. 76-0200 (October, 1976), involving Illinois Bell private line pricing, on behalf of the Illinois Retail Merchants Association, I testified in Docket No. 77-0511 (March, 1978) regarding rates for direct inward dialing, on behalf of several business user intervenors.

I appeared on behalf of the Attorney General of the State of Illinois in several cases involving area code and number conservation issues – Docket No. 94-0315 (the 708 NPA area code split proceeding), Docket Nos. 95-0396/95-0371 (the 312 NPA area code split proceeding) and in Docket Nos. 97-0192/97-0211 (the 847 NPA area code relief proceeding). I was also a witness for the Attorney General in Docket No. 92-0448 addressing alternative regulation and price cap issues, and assisted the Attorney General in its evaluation and response to each of the annual price cap rate adjustment filings that have been made by the Company pursuant to the price cap plan adopted in that proceeding. In May 1996, I appeared on behalf of the Attorney General in Docket 96-0137, a proceeding to transfer charges and services between price cap baskets. I submitted testimony in 1998 and 1999 in Docket 98-0555, the proceeding examining the merger between Ameritech Corporation and SBC Communications, Inc., on behalf of the Government and

Consumer Intervenors, a coalition consisting of the Citizens Utility Board, the Cook County State's Attorney, and the Attorney General of the State of Illinois.

I appeared in Docket No. 95-0157, a resale proceeding (June 1995), and in Docket Nos. 95-0540 and 95-0531, involving the establishment of Illinois Bell wholesale rates (September 1995), and in Docket No. 95-0443 (June 1996), the Ameritech Communications, Inc. application for interexchange and local exchange service authority, on behalf of AT&T Communications of Illinois, Inc. In March 2000, I testified on behalf of AT&T in Docket No. 98-0396/0569 (consolidated) on the subject of nonrecurring charges applicable to Unbundled Network Elements (UNEs) being furnished to CLECs by Ameritech Illinois (March 2000). My most recent appearance before this Commission was in Docket Nos. 98-0252 and 98-0335, addressing alternative regulation issues, on behalf of the Government and Consumers Intervenors group and the City of Chicago (November 2000). Finally, and of direct relevance to the present proceeding, in May 2003 I submitted an affidavit on behalf of AT&T in *Voices for Choices, et al v. Illinois Bell Telephone Co., Inc., et al*, Docket No. 03 C 3290, before the United States District Court for the Northern District of Illinois Eastern Division.

Q. On whose behalf is this testimony offered?

A. This testimony is offered on behalf of AT&T Communications of Illinois, Inc. ("AT&T").

Q. What is the purpose of your testimony?

A. I have been asked by AT&T to adopt the direct testimony originally distributed to the parties in this matter on May 6, 2003 by Joseph Gillan. I have examined that testimony and am in agreement with it. The testimony that follows was originally submitted by Mr. Gillan, with some minor editing.

The purpose of my direct testimony is three-fold:

* To introduce new cost-based UNE loop and nonrecurring rates recommended by AT&T;

* To respond to the testimony of Dr. Aron that <u>embedded costs</u> should be used to judge whether SBC Illinois' UNE rates are established correctly; and

* To address Dr. Aron's recommended industrial policy that argues Illinois' consumers would benefit from high UNE rates and fewer competitive choices.[1]

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[1] Dr. Aron has repeatedly recommended that the Commission curtail UNE-based competition in the past, and the Commission has steadfastly rejected these recommendations as ill-advised. In many ways, Dr. Aron's testimony here is "more of the same," and though it is

The central conclusion of my testimony is that SBC Illinois' existing UNE rates are *supra*-compensatory when contrasted with the appropriate cost standard – SBC Illinois' forward looking economic costs. Dr. Aron's claims to the contrary rely on embedded cost comparisons that, even if conducted properly, would not produce meaningful results. Dr. Aron's testimony is intended to support a policy prescription – essentially an industrial policy favoring high UNE rates and duplicative investment, even where uneconomic – that is not only inefficient and directly contrary to Illinois law, it would force SBC Illinois to increase its own retail rates, as well as force increases in the rates of its competitors.

Q. Before you turn to these specific points, do you have a threshold comment?

A. Yes. It is useful to remember that this proceeding has a very specific purpose: to judge whether SBC Illinois' UNE rates are based on its forward-looking, economic costs (i.e., TELRIC). There is little in Dr. Aron's testimony, however, that addresses forward-looking costing principles, or which offers specific cost recommendations at all. In this sense, Dr. Aron's testimony invites something of a sideshow, initiating contentious debate over issues otherwise unrelated to the docket. To assure that the record is complete, I respond to issues raised by Dr. Aron's testimony, but I generally recommend that the Commission focus its

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cloaked as a "pricing" recommendation this time around, it is no more deserving of adoption than prior iterations.

attention on the *cost* testimony of each party, rather than on the issues raised by Dr. Aron and, as a consequence, discussed here.

Q. Please summarize the UNE rates being recommended by AT&T.

A. AT&T has analyzed the cost studies and other supporting information presented by SBC Illinois in this docket. The details of these analyses are provided in the accompanying testimonies of the witnesses sponsored exclusively or jointly by AT&T. The final corrected rates (i.e., TELRICs plus shared and common costs) are summarized in several attachments to my testimony.

Specifically, Attachment LLS-3 contains the recurring loop rates being proposed by AT&T. For ease of comparison, I have shown both the recurring loop rates proposed by SBC Illinois on SBC witness Michael D. Silver's Schedule MDS-2 and the corresponding AT&T corrected results. In all cases, the proposed rates reflect the recalculated TELRIC as well as the AT&T-recommended loading for shared and common costs.

Similarly, Attachments LLS-4, LLS-5, LLS-6 and LLS-7 contain the nonrecurring rates being proposed by AT&T for stand-alone loops, UNE-P, EELs and Special Access to UNE Conversions, respectively. Once again I have compared these AT&T recommendations with the original SBC Illinois proposals presented on Michael D. Silver's Schedules MDS-3, MDS-4, MDS-5 and MDS-6, respectively.

II. DR. ARON'S EMBEDDED COST ANALYSES

Q. What is the central claim of Dr. Aron's testimony?

A. The principal claim of Dr. Aron's testimony is that "…the current prices for SBC Illinois' unbundled network elements have been set at uneconomically low levels."[2] According to Dr. Aron, current UNE prices do not permit "…even the *opportunity* for SBC Illinois to recover its ongoing costs of providing UNES…" because:

> * SBC Illinois' existing UNE-L and UNE-P are among the lowest prices in the nation; and
>
> * SBC Illinois' UNE margins … are significantly negative.[3]

Of course, the first observation – i.e., that SBC Illinois' existing UNE prices are lower than prices in other states -- says nothing about whether the Illinois rates are compensatory.[4] In fact, as SBC itself argued in Texas, "it is no surprise that one

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[2] Aron Direct, page 4.

[3] Aron Direct, page 5.

[4] My testimony does not independently review the state-by-state comparisons contained in Dr. Aron's testimony. As indicated above, these state-by-state comparisons are not relevant to the cost analysis here. Moreover, these comparisons were not performed by Dr. Aron, nor does she claim that they were even done under her control or review. The fact that I have not challenged these comparisons, however, should not be interpreted as endorsement – rather, there is more than adequate material in Dr. Aron's testimony to rebut, even if the focus is limited to only those portions of Dr. Aron's testimony that address original work.

might find lower UNE rates in states that are so much more dense [than others]," specifically citing Illinois as a State where relatively low rates should be expected.[5] The only relevant standard for judging Illinois' UNE rates are Illinois' TELRIC costs, and nothing can be gleaned on this question from a review of UNE rates in other (mostly dissimilar) states.

Q. What about Dr. Aron's second claim – that existing UNE rates produce a "significantly negative margin." Is that statement accurate?

A. No, it is not. Before I explain why Dr. Aron's conclusion is fundamentally flawed, however, a threshold observation is appropriate – the only correct measure of whether a particular UNE price is economic (and compensatory) is through a comparison to its forward looking economic cost. This principle – that forward looking economic costs are the relevant cost measure – is embodied in federal TELRIC rules, it is a long-standing tenet of Illinois costing rules,[6] and it has been affirmed by the United States Supreme Court.

Despite the clear consensus (and legal mandate) that forward-looking economic costs are the appropriate measure to determine the reasonableness of UNE rates, Dr. Aron has chosen to embrace embedded costs and a rate-of-return based

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[5] SBC's Response to the CLECs' Motions for Reconsideration of Abatement Order, Docket No. 25834, Public Utilities Commission of Texas, pp. 8-9, April 17, 2003.

[6] See Part 791 Cost of Service Rules.

analysis to "support" her claim that the existing UNE rates are below cost. For this reason if no other – and, as I explain below, there are plenty of other reasons – Dr. Aron's testimony should be rejected.

Q. Please describe the basic structure of Dr. Aron's embedded-cost/rate-of-return-based analyses.

A. Dr. Aron presents two "analyses" of SBC Illinois' embedded costs that she claims show that UNE rates in Illinois are below cost. The first analysis is based on embedded cost data filed with the FCC related to interstate switched access service (i.e., the "Switched Access Cost Study"), while the second analysis purports to determine whether UNEs provide SBC with "adequate" cash (the "Cash Flow" Analysis). Neither of these analyses is useful to determine whether UNE loop rates are compensatory (even on an embedded cost/ rate of return basis), although for different reasons.

Q. Is it ever appropriate to determine whether UNE rates are compensatory by looking at embedded costs?

A. No. I do not intend to belabor this point, but SBC's backward-looking, embedded costs should *never* be used to judge the reasonableness of UNE rates. The only costs relevant to UNE rates are SBC Illinois' forward-looking costs – costs that SBC Illinois will incur to replace its plant in the future. Historic costs do not provide the appropriate price signals to either SBC or an entrant because they reflect past circumstances that cannot be altered. In addition, SBC's past costs include a variety of costs unrelated to UNE-activities (some the result of inefficiencies and others due to business decisions and investment initiatives that have nothing to do with its wholesale obligations). Embedded costs reflect the wrong *perspective* (i.e., they look at what was, and not what will be) and, at best, measure the historic cost of an *entire* enterprise, not just that portion relevant to the provision of network elements. The bottom line is that Dr. Aron's embedded analyses are <u>useless</u> to judging the reasonableness of SBC Illinois' UNE rates (even if done reasonably well, which as I discuss below, they were not).

Q. Please describe the first of Dr. Aron's embedded costs analyses – the 'Switched Access Cost Analysis."[7]

A. Dr. Aron's first analysis compares the average revenue for a UNE-L and UNE-P line (assuming existing UNE rates) to what she claims is the "book cost" of UNE-L and UNE-P developed from the ARMIS.[8] Significantly, the ARMIS data that Dr. Aron relies upon reflects legacy cost-allocation rules (Parts 36 and 69), leftover from the days when interstate carrier access service was regulated by rate-of-return.[9] By using these legacy cost allocations are her starting point, Dr. Aron introduces into her analysis each flaw and deficiency associated with rate-of-return regulation – deficiencies that have otherwise led SBC Illinois' to *reject* rate-of-return regulation for its Illinois services (by electing alternative regulation), and which caused Congress to *specifically* reject rate-of-return as the process to establish cost-based UNE rates. As Congress mandated, prices for network elements shall be "…based on the cost (determined without reference to a rate of return or other rate-based proceeding)."[10] As the Supreme Court noted:

[7] See Table 1, Aron Direct, page 8.

[8] ARMIS stands for "Automated Reporting Management Information System," which is the system used by the FCC to routinely collect and publish certain financial and operational information.

[9] Part 36 allocation rules assign book cost between the interstate and intrastate jurisdictions. FCC Part 69 rules allocate embedded costs among interstate access categories such as common line, switching and transport.

[10] Section 252(d)(1)(A)(i), Telecommunications Act of 1996.

> For the first time, Congress passed a ratesetting statute with the aim not just to balance interests between sellers and buyers, but to reorganize markets by rendering regulated utilities' monopolies vulnerable to interlopers …
>
> While the Act is like its predecessors in tying the methodology to the objectives of "just and reasonable" and nondiscriminatory rates, it is radically unlike all previous statutes in providing that rates be set "without reference to a rate-of-return or other rate-based proceeding." The Act thus appears to be an explicit disavowal of the familiar public-utility model of rate regulation … in favor of novel ratesetting designed to give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbents' property.[11]

Despite the clear direction that a traditional cost-of-service approach *not* be used to establish UNE rates, Dr. Aron's basic analysis is nevertheless premised from *exactly* just such a scheme. The FCC's Part 36/69 rules are precisely the type of "familiar public-utility model of rate regulation" that the Act "explicitly disavows."

Q. Would Part 36/ 69 Cost Allocation rules provide a reasonable method to estimate the cost of network elements, even if lawful?

A. No. The genesis of Part 36 "jurisdictional" rules has more in common with the negotiation of a political treaty than with economic costing, while the Part 69 cost allocation rules were initially developed to establish access charges that would continue the same toll-to-local revenue flows that existed at divestiture. Both

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11 *Verizon v. FCC*, 2002 (Statutory references deleted).

were created in an environment where public policy viewed pricing as a social, as opposed to costing, exercise. Each takes as its starting point embedded costs, and each was intended to be used within a general framework of rate-of-return regulation. For its part, the FCC abandoned rate-of-return regulation for carriers the size of SBC in 1991, moving instead to a price-cap regime.[12] SBC Illinois' interstate access services are now regulated under a negotiated industry plan set forth by the Coalition for Affordable Local and Long Distance Services (CALLS).[13] In an environment where not even the FCC uses Parts 36/69 for the purpose they were intended -- i.e., mimicking the jurisdictional separations process -- the notion that these rules can reliably estimate the cost of individual network elements (or the UNE-P combination) is absurd.

Q. Did Dr. Aron accurately estimate the "embedded book cost" of UNE-P or UNE-L, assuming such a calculation would be relevant?

A. No. I do not intend to spend a great deal of time discussing the various methodological flaws in *how* Dr. Aron attempted to estimate the "book cost of SBC Illinois' network elements. To do so would imply that correcting Dr. Aron's analysis would somehow make it more useful or reasonable, an implication that

[12] Second Report and Order, Policy and Rules Concerning Rates for Dominant Carriers, Docket 87-313 (1990).

[13] Sixth Report and Order in CC Docket 96-262 and 94-1, Report and Order in CC Docket 99-249, and Eleventh Report and Order in CC Docket 96-45, Federal Communications Commission, Adopted and Released May 31, 2000 ("CALLS Access Order").

would be decidedly false. The fact is that Dr. Aron's basic framework is inherently and systemically flawed, and cannot be "corrected" by more detailed analysis.

Q. What are some of the more obvious flaws with Dr. Aron's estimate of the "book cost" of the UNEs addressed here?

A. Because the Parts 36 and 69 cost allocation rules <u>do not</u> estimate the book cost of network elements, Dr. Aron performed a variety of "adjustments" to develop her estimates. Some of the more obvious flaws with Dr. Aron's adjustments include:

* Dr. Aron grossly underestimates the number of competitive lines, thereby increasing the estimated cost "<u>per line</u>." Dr. Aron *estimates* the number of competitive lines in Illinois as 112,143 (UNE) and 199,366 (resale).[14] The actual numbers of UNE and resale lines in Illinois at the end of 2001, however, were 610,638 UNE lines and 248,569 resale lines – roughly 176% more than the number of lines used by Dr. Aron.

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[14] I find it odd that Dr. Aron chooses to *estimate* values (such as the number of UNE and resale lines provided by SBC Illinois) that her client publicly *reports*.

* Dr. Aron attempts to "back out" from its UNE book cost SBC Illinois' retail-related costs by applying the "wholesale discount" solely to book loop costs, including return. The avoided cost discount established by the Commission, however, is calculated as the ratio of avoided cost to the total retail <u>revenue requirement</u>. By applying this ratio to "book loop <u>cost</u>" only (which would be less than retail revenue on the total service), Dr. Aron thus underestimates the level of "booked cost" that should reasonably be allocated to retail (and other non-UNE activities), even under her embedded-cost approach.

* Dr. Aron assumes that all investment is UNE-related, with no investment caused by retail or non-UNE activities. This assumption ignores all those tall buildings in Chicago (and their associated costs) that house SBC Illinois' marketing functions, not to mention other support investments (such as computers and the like) that have nothing to do with UNE activity. It also ignores the fact that SBC is not required to – and does not – make all of its network components available as UNEs. As such, any embedded cost analysis that fails to exclude those investments that are driven by broadband and other "advanced services" initiatives will operate to over-attribute costs to the subset of SBC's network that is being offered as UNEs.

* Dr. Aron "estimates" that SBC Illinois' 2001 depreciation expense related to UNE-P and UNE-L as $819 million in Table 1 of her testimony. However, SBC Illinois' <u>entire</u> 2001 depreciation expense for its total operations – wholesale, retail; network and everything else – was only $809 million. In other words, Dr. Aron's "estimate" of the depreciation related <u>solely</u> to UNE-L and UNE-P is $10 million more than the <u>total</u> depreciation of the company that year (including unregulated activities). [15] Not only does Dr. Aron manage to allocate *more than* 100% of SBC Illinois' depreciation to its switched and UNE services, Dr. Aron assigns *no* depreciation to SBC Illinois' special access services, even though such services comprised 40% of SBC Illinois' network in 2001.[16]

* Finally, Dr. Aron makes no adjustment to eliminate retail costs embedded in the "book cost" of switching or transport, based on her assumption that any such costs would already be limited to "wholesale marketing." However, Dr. Aron's workpapers claim that SBC spent more than $27 million in 2001 "marketing" local switching (at least as adjusted by Dr. Aron).[17] This Commission is well aware of SBC Illinois' longstanding

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[15] Dr. Aron's work papers indicate that this particular error (i.e., assigning more depreciation cost than exists) is limited to Table 1 of her testimony.

[16] ARMIS 43-08 (2001).

[17] SBC Illinois' ARMIS 43-01 Operating Expense includes $4.5 million for Local Switching – Marketing. My understanding of Dr. Aron's methodology is that she multiplies this "interstate" amount by 6.13 to arrive at her estimate of the total company expense, thereby increasing the $4.5 million that SBC Illinois claimed it incurred marketing interstate local

opposition to UNE-P and unbundled local switching, and if SBC Illinois' spent more than $27 million *encouraging* carriers to purchase this network element (as suggested by Dr. Aron), they hid the effort well.

There is no point in attempting to correct Dr. Aron's methodology for these errors, for even if each of the errors was corrected, the Commission would have nothing before it but a slightly less poorly constructed,[18] rate-of-return based, embedded-cost study of precisely the type Congress specifically instructed <u>should not</u> be used to establish UNE rates. The first of Dr. Aron's embedded-cost analyses – the "Switched Access Cost Study" – is materially flawed, hopelessly conceived, and should be rejected in its entirety.

Q. Is Dr. Aron's second embedded cost analysis – i.e. the "Cash Flow Analysis" -- any more reasonable?

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switching to interexchange carriers (a claim worthy of its own investigation) to a total marketing cost for wholesale local switching (i.e., unbundled local switching) to over $27 million.

[18] If the Commission were interested in conducting a traditional rate-of-return-type analysis of UNE rates, it would have to (1) exclude from SBC Illinois' books any imprudent costs, (2) allocate costs (at the least) between its switched and dedicated services, (3) allocate costs between those network components that are required to be made available as UNEs and those that are not, (4) allocate costs between its retail and wholesale services, and (5) then determine a rate-of-return applicable to its lower-risk wholesale arrangements. The results of such an analysis would be dramatically lower than Dr. Aron's estimates (for instance, Dr. Aron assigned zero depreciation cost to the 40% of SBC Illinois' network that consists of special access lines), but would still serve no useful purpose for establishing UNE rates

A. No. In Dr. Aron's "cash flow analysis" she claims that existing UNEs are priced below cost because they do not produce sufficient cash to (1) offset SBC Illinois's operating expense (as assigned by Dr. Aron to UNEs) and (2) extract from CLECs the cash to fund SBC Illinois' capital expenditures for 2001. As to the first of these components – Dr. Aron's estimate of the "booked operating cost" of UNEs – the Cash Flow Analysis is built upon the same errors embedded in the "Switched Access Cost Study" described above (and which need not be repeated here).

In addition to repeating all the flaws of her embedded cost analysis, Dr. Aron's Cash Flow Analysis embraces an entirely new presumption – that is, that CLECs purchasing UNEs should be expected to supply SBC with the cash to fund its capital expansion.

Q. Is it reasonable to assume that CLECs should be responsible for supplying SBC the cash it desires for capital expansion?

A. No, not at all. It is critically important to understand that the issue of providing cash for capital expansion is not the same as asking whether CLECs should pay to <u>use</u> SBC Illinois' capital investment. Nor does it involve whether CLECs should pay rates that provide for a recovery of that investment (over an appropriate time and at an appropriate level); nor does the issue question whether CLECs should pay rates that provide for an appropriate return on SBC Illinois' investment.

Capital costs form an important part of a network element's TELRIC cost, and the proposed UNE rates attached to my testimony reflect that fact.

Dr. Aron's calculation in the Cash Flow Analysis, however, assumes that UNE prices should provide the funds used by SBC to expand its network – that is, UNE prices should supply the cash to pay for SBC Illinois' network expansion as it occurs. In effect, this claim turns the CLECs (through UNE prices) into SBC Illinois' investors by requiring they pay for network facilities "up front" as they are installed, and not over time as the facilities are used by CLECs as well as SBC Illinois' own retail services.[19] TELRIC rates are intended to fully compensate SBC Illinois for its capital investments over the life of the asset, however, and not to provide the cash required up-front to purchase the asset.[20]

Q. Did Dr. Aron even correctly estimate SBC Illinois' capital expenditure per line for Illinois?

A. No. Dr. Aron's analysis attributes SBC Illinois' entire capital expenditure to its switched access services (even though these lines are declining), while attributing none to its dedicated (and broadband) services, even though these lines are

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[19] This sentence assumes that new facilities are made available to CLECs at UNE rates, either under state or federal law. Obviously, if SBC Illinois' cap ex budget is being expended on facilities that SBC Illinois' intends to *deny* to CLECs, any suggestion that CLECs should be required to fund such an expansion is beyond fanciful, it is absurd.

[20] If that were the case, then the CLECs would more properly be considered the owner of these new assets, and SBC Illinois should be required to pay them for their use.

increasing. As shown in Table 1 (below), the engine of growth in the SBC Illinois network over the past 5 years – and the most likely cause of its recent capital expenditures – has been non-switched services, not switched facilities.

Table 1: Relative Growth of SBC Illinois' Switched and Dedicated Lines[21]

	Switched Lines	Dedicated Lines
1998	6,865,260	1,824,130
1999	6,955,773	2,402,761
2000	6,884,586	3,597,565
2001	6,532,105	4,130,008
2002	6,621,758	4,272,154
Avg. Growth	-0.7%	26.8%

Under Dr. Aron's Cash Flow Analysis, every UNE loop user should be held accountable for $8.10 per line, per month, of SBC Illinois' capital budget. In addition, Dr. Aron demands an additional monthly contribution of $5.88 per month from each UNE-P line, as though UNE-P users are particularly obligated to fund SBC Illinois' network expansion. To give this item some scale, it is useful to understand that Dr. Aron's cap ex "tax" on UNE-P is more than 3 times SBC Illinois' LRSIC cost of local switching.[22]

[21] Source: ARMIS 43-08. Switched lines are adjusted to include UNE-P lines, as provided by SBC Illinois in response to AT&T Data Request JG 4b.

[22] See Tab 5.2, SBC Response to AT&T JG-3 (confidential) for the specific LRSIC value.

Q. Dr. Aron claims that Illinois' UNE rates are discouraging investment.[23] Is there any evidence to support this claim?

A. No, there is not. Table 2 below compares SBC Illinois' capital budget for the 4 years prior to the passage of the federal Telecommunications Act to its expenditures after the Act was adopted and UNE rates were set.[24] As Table 2 shows, SBC Illinois' capital expenditures increased significantly, roughly *doubling* after passage of the Act.

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23 Aron Direct, page 14.

24 ARMIS provided only 4 years of information (starting in 1992) prior to the Act's passage to include in the comparison.

Table 2: SBC Illinois' Capital Expenditures[25]
(Comparing Pre-Act and Post-Act)

Year	Cap Ex	Comparison
1992	$576,962	Average Cap Ex Pre-Act $419,609
1993	$534,416	
1994	$499,655	
1995	$487,012	
1996	$628,776	Average Cap Ex Post-ct $800,605
1997	$827,566	
1998	$741,562	
1999	$715,896	
2000	$875,529	
2001	$1,078,798	
2002	$736,111	

I also note that SBC was well aware of Ameritech's UNE rates at the time it chose to acquire the company. SBC could have decided to enter Illinois as a CLEC, leasing (what it now claims are below-cost) UNEs, offering bundles of local and long distance service,[26] competing like any other entrant. Yet, SBC chose to gain access to the network by purchasing Ameritech, being held to the market-opening requirements of Section 271, which include leasing UNEs to others. Having voluntarily embraced the obligations of Illinois' incumbent – and paying a premium in the process – SBC now claims that the role places it at a disadvantage, even though it had every opportunity to compete as an entrant. At some point, SBC should be judged by its behavior, and not the theoretical musings of its witnesses.

[25] Source: ARMIS 43-02.

[26] SBC would not have been restricted from offering interLATA long distance services in Illinois had it decided to compete as a CLEC.

Q. Dr. Aron also cites studies by some investment firms that she claims confirm her conclusions.[27] Are these analyses useful?

A. No, they are not. First, investment firms do not commonly evaluate the profitability of SBC's wholesale operations, but rather look at the overall profitability of the company. Because a useful wholesale product (such as UNE-P) causes the incumbent to lose *retail* market share, investment firms tend to focus on the financial effects caused by a loss of retail market share rather than evaluate the separate question, are wholesale rates compensatory?[28]

Second, it is not at all clear that the investment firms cited by Dr. Aron actually share her view of UNE rates. For instance, the Merrill Lynch analysis cited by Dr. Aron opines:

> As UNE rates continue to be scrutinized in front of (or in some cases in parallel with) any new RBOC 271 filing at the state level, it seems inevitable that we will continue to see pressure on UNE rates driving further retail to wholesale access lines moves at the RBOCs. This is the direct result of the spread between UNE-P and retail rates continuing to widen, offering a larger window of

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27 See, for instance, Aron Direct, page 21, Table 3.

28 Obviously, even a compensatory wholesale service is likely to lead to revenue erosion because lost retail sales should be expected to produce revenue reductions that are greater than the replacement wholesale revenue.

> profitability for potential competition for local exchange service (just as the Telecommunications Act of 1996 intended).[29]

Finally, I note that the investment firms cited by Dr. Aron cannot seem to agree with each other, much less with the conclusions offered by Dr. Aron. Consider the following Table 3 that compares the *existing* UNE-P rates in Illinois as summarized by Merrill Lynch and UBS Warburg. Understand that these analysts are measuring the same quantum – namely, what CLECs pay to lease UNE-P from SBC in Illinois based on the UNE rates currently in effect.

Table 3: Comparing Investment-Firm Estimates of UNE-P

Investment Firm	Illinois UNE-P Rate
Merrill Lynch	$14.82
UBS Warburg	$8.92

As illustrated by Table 3, these investment firms were unable to even apply the *existing* UNE rates consistently to determine the average revenue from UNE-P in Illinois.[30] For a broader discussion of the difficulties inherent in estimating the financial implications of UNE competition, I attach to my testimony a recent Phoenix Center paper (Attachment LLS-1) discussing this issue.[31] The bottom

[29] *The Telecommunicator*, September 23, 2002, Merrill Lynch, page 3. Emphasis Added.

[30] Remarkably, even though these firms are calculating the same data point – the average revenue collected under the standard UNE tariff -- the Merrill Lynch estimate is nearly 2/3rds larger than the UBS Warburg estimate. Such disparity does not lend itself to analytic confidence in the accuracy of these reports or their conclusions.

[31] *Bell Companies as Profitable Wholesale Firms: The Financial Implications of UNE-P*, Phoenix Center Policy Paper Number 17, November 2002.

line is that Dr. Aron's cited investor reports (which have their own significant deficiencies) do not demonstrate that Dr. Aron's claims are reasonable.

III. DR. ARON'S INDUSTRIAL POLICY

Q. Is Dr. Aron's testimony limited to conducting embedded cost analyses?

A. No. Dr. Aron's testimony also includes a number of "side discussions" that collectively form an industrial policy intended to rationalize the view that "high" UNE rates would be sound public policy (albeit not one adopted by Congress). It is unclear exactly why this testimony would be relevant to a proceeding intended to review the cost justification for UNE loop rates (and certain non-recurring charges) in Illinois. However, given the importance of this proceeding to local competition in Illinois, I will briefly address Dr. Aron's other points.

Q. Dr. Aron implies that the Commission shouldn't worry about the competitive consequences of UNE rate increases (up to and including an actual price squeeze) because CLECs always have the option of resale.[32] Is this a reasonable view?

A. No. Remarkably, Dr. Aron takes the view that:

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[32] Aron Direct, page 27.

> The availability of resale under TA96 ensures that there is available to CLECs a method of entry that provides a profit margin.[33]

It is hard to fathom an economic expert testifying that TA96-based resale "ensures … a profit margin," given the highly publicized experiences of those entrants attempting the strategy. Local service resale has been declining for years, as entrant after entrant concluded it was unprofitable. Resale is no substitute for UNE-based entry, and the effect of increasing UNE rates would be higher consumer prices and/or fewer choices. Resale cannot temper these consequences.

Q. Does Dr. Aron ever acknowledge the harms created by uneconomically high UNE rates?

A. No. Local competition is only now beginning to emerge, with UNE-based competition a critical element. UNE rates that exceed SBC Illinois' forward looking economic costs will retard CLEC entry, frustrate product innovation and, importantly, will lead to higher prices to consumers. Indeed, if the Commission were to adopt SBC Illinois' claimed UNE-costs – ill advised as that action would be, for so *many* reasons – the prices of a number of SBC's services would need to be increased because SBC today offers consumers retail rates that are *less* than what it claims are its forward-looking economic costs. Of course, any competitive service priced below cost (including, for its non-competitive

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33 Aron Direct, page 27.

components, the wholesale price imposed on entrants) violates the Illinois Public Utilities Act,[34] and its retail rates must increase as a matter of law. Even a cursory review of SBC Illinois retail rates reveals this concern,[35] and my preliminary review indicates that SBC Illinois' studies underestimate imputed costs. For instance, SBC Illinois' improperly "imputes" the LRSIC cost for the switching port in its Network Access Line study,[36] ignoring the fact that the Commission found that local switching is a non-competitive service when it ordered Ameritech to provide it in the Docket 95-0458/0531. The point is that UNE rates directly affect the rates paid by end-users -- including end-users served by the incumbent – and the increases sought by SBC Illinois in this proceeding would directly, and negatively, impact consumers.

Q. Is Dr. Aron's "industrial policy" testimony – i.e., her tirade against UNE-P -- relevant?

A. No. As the Commission knows, this is not the first time that Dr. Aron has opposed UNE-P. Even though UNE-P is a clear, unequivocal requirement of the Illinois Public Utilities Act,[37] Dr. Aron continues to sponsor testimony

[34] Section 13-505.1.

[35] See, for instance, Telecommunications Division Staff Report, TRM 1454, December 27, 2002, page 2.

[36] See Tab 5.1 (Confidential) attached to SBC Illinois' Response to JG-3.

[37] See Section 13-801(d)(4).

encouraging the Commission to disregard this critical entry strategy. As the Commission recently noted, in rejecting Dr. Aron's testimony once again:

> The Commission and the FCC have rejected Ameritech's "CLECs must build to be competitive" argument on so many occasions that citation is unnecessary. At some point, we are confident that CLECs will undertake the infrastructure investments necessary to serve their clients. Until that occurs, the United State's Congress and now, the Illinois Legislature have established a different scheme, one which Ameritech finds uncomfortable, but one we have been charged with enforcing.[38]

Dr. Aron's attack on UNE-P in this proceeding is particularly disingenuous. This docket is about establishing cost-based <u>loop</u> and various nonrecurring rates. Increasing loop rates would likely have a *greater* impact on UNE-L based competition (which Dr. Aron avows to favor) where loop rates are 100% of the UNE cost, then UNE-P (where the loop rate is only one – albeit significant – cost component). The point is that Dr. Aron has managed not only to file anti-UNE-P testimony in a proceeding where it is not relevant, she is doing so in conjunction with UNE rate recommendations by her client that will harm most precisely the form of competition (UNE-L) that she claims to prefer.

Q. What appears to explain Dr. Aron's animosity towards UNE-P?

[38] Order, Docket No. 01-0614, June 11, 2002, page 56.

A. If there is a single paragraph in Dr. Aron's testimony that explains her unrelenting opposition to UNE-P, it is the following:

> CLECs that rely on the incumbent's network do not, by definition, provide any innovation in the provision of the underlying facilities. Accordingly, UNE-P and resale providers have fewer avenues by which to make contributions to the marketplace. The result is not only less investment, but also, very fundamentally, less competition.[39]

The fundamental flaw in Dr. Aron's industrial policy is that it assumes that the best judge of "contributions to the marketplace" is Dr. Aron, as opposed to the individual consumers that vote with their checkbook when they choose their preferred provider. Assuming for the moment that Dr. Aron is correct that UNE-P providers cannot "innovate" in the way facilities are used,[40] the larger issue is why does Dr. Aron believe that only facilities-related innovation is important?

As a practical matter, in the analog-voice market where generally UNE-P competes, the network is *intentionally* a commodity. The fact is that most

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39 Aron Direct, page 35.

40 Although not the subject of this testimony, the fundamental architecture of the local network has changed over the past decade with the introduction of the "Advanced Intelligent Network" call model. In an AIN environment (which SBC has implemented), services can be defined in remote databases that use the signaling system to invoke different switching commands. In this way, the local network becomes a service-neutral transmission and switching matrix (UNE-P), while service creation and enhancement become software-defined capabilities external to the physical network. This is not the place to debate the issues that will arise as the AIN architecture is opened to competitors. However, it is useful to note this is just one more area – i.e., the claim that UNE-P providers cannot innovate in how facilities are used -- where Dr. Aron's testimony is simply wrong.

network facilities – particularly analog network facilities –are designed to perform relatively generic functions that are not the source of product differentiation. This may seem obvious, but voice conversations, even when carried over different facilities, are *supposed* to sound identical. Manufacturers have spent a great deal of money to make sure that different equipment is interoperable precisely so that it can be introduced into the network *without* customers being able to tell the difference. The offering of basic local service is an exercise in network engineering, not art or culinary improvisation. Whether an entrant *leases* capacity in the incumbent's 5E, or installs its *own* 5E, the services that it can offer are essentially the same. As a result, innovation in the voice marketplace is not generally found in the network but, rather, involves other tangible dimensions of a service -- how the service is priced, packaged, and supported.

Q. Are these "non-network" dimensions important?

A. Yes. The importance of non-network skills in the local marketplace cannot be overemphasized. Many of the innovations that attract customers involve pricing and support capabilities that reside *outside* the physical network. The size of the local calling area, whether a service seamlessly transitions between "local and toll," the interrelationship between the local service and other customer support activities (such as web design or specialized billing) are all important service elements that have nothing to do with the generic switching and transmission platform used to transmit calls. UNE-P enables companies to first focus on these operational dimensions, and thus bring competitive differentiation to nearly every facet of service design other than those linked to the network itself.

Finally, in the time since SBC Illinois offered UNE-P (a history that needs no recounting here), as of the original filing date of Mr. Gillan's testimony more than 650,000 Illinois customers have validated the importance of this entry strategy. These customers each determined through their individual choices the "contribution to the marketplace" of UNE-P. Dr. Aron's personal opinion of UNE-P is relevant only to *her* choice of local service provider -- it should not be used to disregard the counter views of the 650,000 (and growing) Illinois consumers that disagree.

Q. Is SBC well aware of the importance of non-network innovation in the voice market?

A. Yes. SBC readily admits that it is being forced to innovate in <u>response</u> to UNE-P based competition. As SBC has explained to its investors:

> SBC has responded to intensified UNE-P-based offers on several fronts: by introducing innovative new packages …
>
> ***

> In mid-June, SBC launched in its Michigan markets an innovative unlimited local toll/zone calling plan …[41]

Obviously, if SBC has to innovate to "catch-up" with UNE-P based competition, then UNE-P must have first enabled innovation for the cycle to begin. Moreover, UNE-P is nothing more than the local equivalent of the long distance wholesale arrangements that SBC uses to offer its interLATA services. To my knowledge, neither SBC (nor Dr. Aron) has ever claimed that SBC's long distance entry would make no "contribution to the marketplace" unless SBC was first required to construct a new national long distance network.

Q. Dr. Aron also claims that existing UNE rates are resulting in "marketplace distortions" in Illinois.[42] Do you agree?

A. No. To begin, it is useful (once again) to recall that the purpose of this proceeding is to establish cost-based UNE rates, and cost-based UNE rates will encourage efficient entry, whether Dr. Aron likes its form or not. It is in this section of her testimony that Dr. Aron's bias is most apparent – in Dr. Aron's view, if the *type* of competition is not to her liking, then she *assumes* the UNE rates must be wrong. Specifically, Dr. Aron observes that:

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41 SBC 2nd Quarter Investor Briefing, July 23, 2002.

42 Aron Direct, page 42.

- * Since March, 2001, there have been no net new facilities-based entrants, and

- * Although "facilities-based line additions are substantial … growth has decreased," while UNE-P has continued to grow steadily.[43]

Accepting these observations as accurate, the real question is what do they mean? The fact that no new facilities-based entrants have come into being since March 2001 should not be a surprise -- capital markets are essentially closed to CLECs, in part a response to the widespread spate of bankruptcies by CLECs following Dr. Aron's preferred entry advice (build no matter what). Even Dr. Aron has (in prior affidavits) recognized that facilities-based entry has its limits:

> The marketplace cannot, and efficiency will not, support hundreds of new landline telecommunications carriers. Considerable overlap exists in CLEC networks, and the market will not support all of them.[44]

How Dr. Aron can express the view that there were "too many" facilities-based CLECs in July 2001, while expressing surprise that "no new net entry" has occurred in Illinois since then, is a question I will let her creatively explain on rebuttal.[45] In any event, it is impossible to understand how *more* facilities-based

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43 Id.

44 Reply Affidavit of Dr. Debra J. Aron on Behalf of Ameritech Michigan, Michigan Public Service Commission Case No. U-12320, July 30 2001.

45 Interestingly, in Dr. Aron's July 2001 Affidavit, she touted the success of the "four horseman" of the CLEC industry (Allegiance, McLeod, Time Warner and XO) as evidence that "each of the entry paths provided for by TA96 can be used successfully by efficient firms." In

(which includes UNE-L based) entry would result if SBC Illinois is permitted to increase its loop rates as requested in this proceeding. If anything, such increases will only further discourage facilities-based strategies, not produce additional competition.

Second, the fact that UNE-P has continued to show a "steady pace" of net additions, while facilities-based line additions are only "substantial" does not mean that one form of entry is occurring at the expense of another. Rather, each strategy is used to serve different customer segments. UNE-P is used primarily to offer analog voice services to smaller users (residential and small business). In contrast, UNE-L is better suited for providing more complex services to larger customers, particularly in urban areas. As a result, because the strategies serve distinct customer subgroups, there is no reason to expect that one would grow at the expense of the other.

In fact, the Illinois Commission <u>expected</u> that the markets used by UNE-P and UNE-L would likely differ, and noted this difference in its Order first requiring UNE-P seven years ago:[46]

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the time since Dr. Aron offered this prediction, McLeod and XO have gone bankrupt, Allegiance is expected to go into bankruptcy, and Time Warner's stock has dropped by more than 88%.

[46] I will rely on the Commission drawing its own conclusion when comparing the relative accuracy of its own prediction concerning the usefulness of UNE-P seven years ago, to Dr. Aron's 2 year-old prediction on the viability of certain facilities-based carriers.

> In the Ameritech Customers First Order, by ordering unbundled loops and local call termination, the Commission sought to enable carriers which provided their own switch and transport to utilize the Ameritech network to provide local exchange competition. However, due to economic realities, this form of competition will be costly and slow to develop, possibly limited to densely-populated areas and large-volume users. The services requested by AT&T and LDDS [resale and UNE-P, respectively] would more readily be available to provide quicker and broader based competition to the entire territories of Ameritech and Centel, including residential and small business users.[47]

Given that UNE-P and UNE-L should be expected to serve different markets, there is no basis to "blame" the decline in UNE-L based entry (which Dr. Aron implies)[48] on the introduction of UNE-P. The growth of UNE-P in 2001 (and on) can be attributed to SBC Illinois finally implementing the Commission's Orders with respect to UNE-P (and its necessary component, shared transport), thereby opening the mass-market to competition. The slowing of facilities-based entry should be expected, given the financial performance of competitors pursuing that strategy, as well as the fact that it is (at least relative to UNE-P) past its infant-entry phase when growth is relatively rapid.

Q. Would it be reasonable to expect that SBC Illinois would reduce its investment in its Illinois network because of obligation to unbundle loops (alone and in the UNE-P combination)?

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47 Order, Illinois Commerce Commission Dockets 95-0458 and 95-0531 Consolidated, June 26 1996, Page 56.

48 Aron Direct, page 44.

A. No. As a practical matter, it is important to understand the relative weight of the UNE-wholesale and retail markets on SBC's Illinois' management. As shown in Table 4, SBC Illinois' retail demand dwarfs its unbundling volumes. SBC's investment strategies are going to be driven more by the requirements of its retail business (which, as shown below, involve more than 91% of its network), than by its unbundling obligations (which involve less than 9% of its operations).

Table 4: Relative Size of SBC's Retail and Wholesale Markets[49]

	Lines	**Share**
Retail Lines		
Switched Lines	5,969,763	53.2%
Special Lines	4,272,154	38.1%
Wholesale Lines		
UNE-L	332,759	3.0%
UNE-P	651,995	5.8%
Total Lines	11,226,671	

There is simply no basis to claim that UNE-P discourages carriers (entrant or the incumbent) from continuing to make network investments that make sense. In this regard, the Texas Public Service Commission *explicitly* rejected SBC's "UNE-P harms facilities-deployment" argument in a proceeding requiring that UNE-P remain available in that State:

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[49] Source: Retail Lines (ARMIS 2002) and Wholesale Lines (SBC Response to AT&T RFI JG4a and JG4b).

> With regard to the long run impact on the incentive for infrastructure investment, the Arbitrators were not convinced by SWBT's argument that the availability of UNE-P will crowd out investment in the analog network. Moreover, the Arbitrators find that continued duplication of the existing legacy analog network may constitute an inefficient use of scarce industry resources. Inefficient use of available resources is not in the public interest.[50]

Q. Finally, Dr. Aron complains that entrants are competing most heavily for those customers that SBC Illinois overcharges the most.[51] Should the Commission be concerned that competition occurs most quickly for the highest margin customer?

A. No. SBC pejoratively labels CLEC pricing plans as "cherry picking" because these plans are most attractive to customers desiring a bundle of local, long distance and features. But the ability to offer bundles is one of the benefits of competition (and is frequently cited as such by SBC when seeking interLATA authority).

SBC Illinois has a history of trying to use UNE proceedings to preserve its retail pricing strategies, even when they are not cost-based. For instance, in an earlier proceeding establishing UNE rates, the Commission found the following with respect to SBC Illinois (under its former label, Ameritech)

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50 *Arbitration Award*, Docket 24542, April 29, 2002, page 84 (footnotes omitted).

51 Aron Direct, page 41.

> Ameritech's own testimony reveals that SCIS [the local switching cost model] overstates the usage-cost of local switching and produces results intended to support Ameritech's pricing structure and objectives, not its underlying costs.[52]

A similar tack is at work here. Fundamentally, Dr. Aron complains that competition is forcing SBC Illinois to rationalize its retail pricing systems because it must respond to packages offered by competitors to customers that today pay unreasonably high rates. Such price reform, however, is one of the *benefits* of competition, and it is generally (with the apparent exception of Dr. Aron) a result *encouraged* by economists, not derided.

Q. Is SBC similarly competing for the higher-margin customer segment?

A. Absolutely. For instance, SBC recently announced a "comprehensive, next generation, consumer bundling strategy" that is targeted to the top 30% of the market:

> This initiative [the "next generation bundling strategy"] starts today with the launch of SBC Total Connections, a premium bundle of services, provided by SBC subsidiaries, appropriate for communications-intensive household – approximately 30 percent of the SBC consumer base.[53]

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[52] Second Interim Order, Illinois Commerce Commission Dockets 95-0486 and 96-0569, February 17 1998, page 59.

[53] *SBC Unveils Comprehensive, Next-Generation, Consumer Bundling Strategy to Provide Customers New Levels of Control and Flexibility*, SBC Press Statement, November 18, 2002. *See* Attachment LLS-2.

There should be no surprise that competition will bring the most benefit to those consumers most disadvantaged by the current pricing structure. Dr. Aron's testimony, however, implies that these customers are some form of market entitlement – i.e., only SBC should decide when they are offered bundles, not the competitive process.[54]

Q. Does this conclude your direct testimony?

A. Yes.

[54] Remarkably, Dr. Aron even implies that SBC Illinois uses its supra-competitive profits for the public good, as opposed to reporting these profits as earnings to its shareholders, claiming that SBC Illinois' rivals (page 41) "… poach the sources of the very revenues that enable SBC Illinois to serve high cost, low revenue residential customers …".